Choreographing a Foundation Disappearing Act

*by Jane C. Nober**

There's more to closing down a private foundation than packing up and turning off the utilities. Here are some questions, considerations and IRS direction.

Sometimes it is time for a private foundation to disappear—assets may have dwindled significantly or family members no longer share a common charitable vision. Perhaps the founder decreed that the fund would last only a certain term of years. Whatever the reason, foundation managers seeking to end the existence of a private foundation cannot simply declare the foundation terminated and walk away. There are decisions to make, procedures to follow, and, of course, tax forms to file. This article discusses foundation managers' choices and obligations when they seek to shut down a private foundation and recent IRS guidance that should make the process easier.

Pick a Partner

When a foundation chooses to terminate (note that the legal regime for foundations that terminate involuntarily on account of misdeeds is beyond the scope of this article), its assets must be distributed to other charitable organizations. This requirement ensures that the foundation's assets are devoted permanently to charitable purposes. Whether the intended recipients of the foundation's assets are public charities of one type or another or private foundations largely determines the rules that the private foundation must follow as it disbands.

The easiest way for a private foundation to terminate is for it to transfer its assets to one or more public charities that are described in Section 509(a)(1) of the Tax Code (organizations that are publicly supported) and have been in existence for more than 60 months. Most community foundations meet those requirements. A private foundation that chooses this path does not have to give the IRS advance warning of its intention to terminate. Indeed, its only obligation to the IRS is to note on its 990-PF for the year in which the transfer has occurred that this will be the organization's final return. The private foundation may still be obligated to undertake dissolution procedures at the state level (filing a plan of dissolution with a state court, for example), but its dealings with the IRS will be very simple, as this type of distribution effects an automatic termination of the foundation's existence.

Where one of the intended recipients of the private foundation's assets is something other than a public charity that has been in existence for 60 months, the process gets more complicated. Prior to the issuance of recent IRS guidance on foundation terminations, many lawyers would not initiate such a transaction without seeking a letter ruling from the IRS, a lengthy and expensive undertaking. Revenue Ruling 2002-28 and Revenue Ruling 2003-13, published in May of 2002 and January of 2003, respectively, consider what happens when a private foundation opts to distribute its funds to other private foundations, newly-established public charities described in Section 509(a)(1), or public charities described in other parts of Section 509, including supporting organizations. Those rulings

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should help resolve most basic questions about those types of terminations and reduce the amount of charitable dollars spent on obtaining letter rulings for routine transactions.

Termination Tax Tango

Private foundations that transfer their assets to charities other than 509(a)(1) public charities that have been in existence for more than 60 months do not automatically terminate their private foundation status. They must notify the IRS of their intention to terminate in order to free themselves permanently from the obligations of private foundation status (filing Form 990-PF, paying excise tax and the like). With this required notification comes the potential imposition of an onerous termination tax on the terminating foundation's net assets, a levy that seeks to recapture all of the tax benefit that the private foundation has ever provided to its donors. Happily, the new revenue rulings give foundation managers explicit directions on how to avoid paying this tax.

Do the Two-Step

The rulings recommend a two-step approach for private foundations seeking to distribute their assets to organizations other than long-established publicly supported charities and terminate. First, the private foundation should distribute its assets. Then, as soon as the day after such distributions are made, the private foundation should notify the IRS of its intention to terminate. Because the private foundation will have no net assets on this date, the termination tax will be zero. However, the private foundation's notice to the IRS termination must "set forth in detail the computation and amount of tax imposed," though the bottom line will be no tax.

This two-step process is recommended for distributions to other private foundations, newly created publicly supported charities and supporting organizations. There is no fee, and no IRS form, for termination notices, which should be addressed to: Manager, Exempt Organizations Determinations, Tax Exempt and Government Entities Division (TE/GE), P.O. Box 192, Covington, KY 41012-0192. Merely submitting a Form 990-PF marked "final" does not constitute notice of termination.

When a private foundation makes a terminating distribution and notifies the IRS of its intention to terminate, it will be obligated to file a Form 990-PF for the taxable year in which the distribution was made. It will have no further IRS filing requirements, but may have state level dissolution requirements.

A private foundation may distribute all of its net assets to other charities and choose not to terminate. In this case, it will be obligated to file a Form 990-PF for the distribution year. In subsequent years, if it has no assets and no activities, it will not be required to file. If it ever holds assets or undertakes activities, its filing obligation will resume.

The Tax Liability Shuffle

The two revenue rulings discuss at length whether terminating distributions subject private foundations to the various excise taxes imposed under Chapter 42 (such as the taxes on excess business holdings and jeopardizing investments, as well as the taxes on net investment income and taxable expenditures). The good news is that the terminating transfers in themselves do not generally give rise to excise tax liability. However, transfers from private foundations can shift tax liabilities to the transferees.

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For example, if a family decides to divide a family foundation into smaller parts for various branches of the clan, the liability for any excise tax due on the net investment income of the original foundation will transfer with the assets. If the original foundation has not paid its tax bill, the transferee foundations will have to do so.

Similarly, if the original foundation had outstanding expenditure responsibility obligations, the transferee foundations will be required to pick these up or face tax penalties. The original foundation and the various transferees may agree to assign particular expenditure responsibility obligations to specific transferees.

Where the transferee is a private foundation controlled by the same people as the terminating foundation, other issues may arise. An infusion of assets from another foundation, for example, may push the transferee over the applicable limits on excess business holdings.

A well-crafted agreement between the terminating foundation and the transferees will cover those and other issues. Assistance of knowledgeable counsel is essential to ensure that the foundation's termination provides the maximum benefit to other charities.

Resources

- **IRS Website: Voluntary Termination of Private Foundation Status**
- IRS Revenue Rulings **2002-28** and **2003-13**
- Jane C. Nober. "**Merging Ahead**"

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